

Capital Markets Tax Committee of Asia
c/o Baker & McKenzie
14/ F Hutchison House
10 Harcourt Road
Central, Hong Kong

October 15, 2005

By Hand

Clerk to the Bills Committee
Legislative Council
Central
Hong Kong
Attention: Ms Debbie Yau

Fax: 2869-6794

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Dear Sir:

Re: Exemption of Offshore Funds from Profits Tax

Thank you for inviting us to the Bills Committee meeting on October 25, 2005 to discuss The Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (“The Bill”). The Capital Markets Tax Committee of Asia Hong Kong Chapter (“CMTC”) appreciates your willingness to consider our comments.

We support The Bill. It is a welcome step to clarify tax uncertainty and bring Hong Kong in line with other major financial centers. We believe that the explicit exemption of offshore funds from Hong Kong profits tax is essential for promoting and retaining the fund management industry in Hong Kong.

Background

Until recently, the Inland Revenue Department (“IRD”) did not attempt to subject offshore funds that trade in Hong Kong securities to Hong Kong tax. However, a few years ago the IRD appeared to change its tax policy by issuing profits tax returns and query letters to a number of offshore funds.

Technically, Hong Kong tax law currently subjects any offshore entity that enters into transactions through its agent in Hong Kong to Hong Kong profits tax. However, explicit exemption is given to authorized unit trusts, authorized mutual fund corporations and certain other collective investment schemes which are bona fide widely held and supervised by a suitable supervisory authority within an acceptable regulatory regime. Unfortunately, the vast majority of offshore funds are not able to utilize these exemptions.

Most funds are incorporated in unacceptable jurisdictions, not authorized by recognized authorities, and/or targeted to a small group of wealthy investors. The Hong Kong investment industry also manages a significant amount of money for other offshore entities such as pension schemes, government and semi-government authorities, insurance companies, other companies and wealthy individuals. All such clients have no statutory protection from tax.

In practice, the IRD has long taken the view that offshore entities that do not have their own offices or employees in Hong Kong do not carry on business in Hong Kong and therefore are not subject to Hong Kong profits tax. The then-Acting Financial Secretary, Mr. Donald Tsang, wrote in 1993: "In practice, the Inland Revenue Department does not actively pursue, for profits tax purposes, non-residents who buy and sell Hong Kong shares." Other government officials have repeatedly reassured the industry with this view. This position has served Hong Kong well by encouraging many offshore funds to invest in Hong Kong and many offshore fund managers to establish a presence in Hong Kong without incurring a Hong Kong tax charge at the fund level.

If Hong Kong were to enforce the technical provisions in the existing Revenue Ordinance and subject offshore funds to profits tax, then Hong Kong would be at an incredible disadvantage as a financial center. No major jurisdiction in the world subjects offshore funds to direct taxation. Countries such as the United States provide a general exemption to all types of foreign investors. Hong Kong would find itself unique in the world as a jurisdiction that subjects offshore funds and other offshore investors to profits tax.

Unquestionably, if the IRD were to pursue enforcement actions against offshore funds, then large portions of the fund management industry would move out of Hong Kong. This result is not in line with the Hong Kong government's desire to build Hong Kong into a strong international financial center. It would be most unfortunate if Hong Kong were to become the most aggressive taxing jurisdiction in the world with respect to offshore funds.

In light of the industry concerns, for the last several years the IRD has suspended enforcement proceedings against most offshore funds. The Government and industry agree that it is now time to legislate to ensure that tax concerns do not destroy the fund industry in Hong Kong.

The Bill

To reinforce Hong Kong's status as an international financial centre, the Hong Kong Government has proposed to exempt offshore funds from profits tax. Unfortunately, the technical drafting of this proposal has proven very difficult. The Bill was introduced to the Legislative Council in July 2005 to implement the proposal. We greatly appreciate the hard work that the government has put into this draft legislation and we understand the government's concerns that the exemption should not be abused for tax avoidance purposes.

The Bill has adopted many suggestions submitted by the industry during the consultation exercise. In particular we are pleased that the independence and association restrictions

have been removed. In addition, the Government has allayed many other industry concerns with the release of their Supplemental Notes. Generally, we are happy with the positions described in the Supplemental Notes. However, we feel that several interpretations described in the Supplemental Notes should be incorporated into the text of the legislation. With the minor revisions explained in Appendix A, we think that the industry should be able to comply with the criteria contained in the proposed legislation.

We trust that you find these comments useful. Should you wish to discuss the above further, feel free to call me at 2848-6801 or send me an email at David.Sutherland@MorganStanley.com.

Yours truly,

David Sutherland
For and on behalf of
Capital Markets Tax Committee,
Hong Kong Chapter

L/dc/Hong Kong/Offshore Funds 10-2005 letter.doc

SUGGESTED TECHICAL CORRECTIONS TO THE REVENUE (PROFITS TAX EXEMPTION FOR OFFSHORE FUNDS) BILL 2005

CMTC appreciates the Hong Kong Government's efforts to address the tax issues facing nonresidents who invest in Hong Kong. We believe that The Bill is an appropriate solution and that the positions that the Government describes in the Supplemental Notes are helpful. However, we believe that it is vital that the positions described in the Supplemental Notes should be given legislative effect through the following two revisions to The Bill.

Residence

The Bill limits the exemption to non-resident persons. A corporate non-resident is defined as a corporation that is centrally managed and controlled outside Hong Kong. In response to concerns from the industry, the government has released Supplementary Notes to clarify the interpretation of management and control.

Generally, the industry is pleased with the language of the Supplementary Notes and with the Government's commitment to incorporate these concepts into a practice note. However, given that practice notes are not legally binding, we suggest that the draft legislative language should be amended by indicating that management and control will be determined "at the highest level of control of the business of the company". This relatively simple change to the legislation should give the industry confidence that the concepts in the Supplementary Notes will have legal significance.

Scope of Exemption

The Bill grants exemption to transactions which (i) amount to "dealing in securities", "dealing in futures contracts" or "leveraged foreign exchange trading" under the Securities and Futures Ordinance (the qualifying product requirement) and (ii) are carried out through appropriately licensed or registered persons in Hong Kong (the specified person requirement). We are concerned that these two requirements as currently drafted would undermine the effectiveness of the proposed exemption.

1. Qualifying Products

The scope of the relevant provisions of the Securities and Futures Ordinance can be difficult for a non-securities lawyer to comprehend. Thus, Stephen Fletcher of Linklaters has prepared a very helpful paper on the qualifying products currently covered in the proposed legislation (copy attached as Appendix B). According to Stephen, the proposed list includes most products ordinarily traded by funds, but does not cover the following products:

- Spot foreign exchange transactions;
- Deposits, certificates of deposit, bills of exchange and promissory notes;
- Borrowing and lending money;

- Unlisted bonds, debentures or notes issued by Hong Kong private companies;
- OTC credit default swaps and other credit derivatives;
- OTC interest rate derivatives (swaps, options, swaptions, caps, collars, floors etc);
- Physical commodities and OTC commodities derivatives;
- Insurance contracts and derivatives over insurance contracts; and
- Other commonly-traded derivative products, e.g. weather derivatives, and energy derivatives.

We understand that the Government did not intend to exclude these types of financial products and we suggest that the legislation be amended to reflect the expanded scope. The best way to include these products may be to add the above list to the existing provisions of the Bill. This is consistent with the Government's position in the Supplemental Notes.

We believe that the Government should reserve the power to add to the list to cater for new products. It would be helpful if the IRD could take note of new products traded by the fund industry in future years and expand the exemption accordingly instead of going through the legislative process with the Legislative Council every time that the industry evolves. Without this power to expand the exempted products, we are concerned that the industry will need additional legislative relieve almost every year.

2. Specified Persons

The proposed legislation requires that an exempt transaction be carried out through an appropriately licensed or registered person under the Securities and Futures Ordinance. There may be important occasions where this requirement will not be met. Most funds trade a wide geographic range of products. A fund may trade swaps denominated by Korean equities through a person that is neither licensed nor registered in Hong Kong. Gains from such OTC instruments may be Hong Kong-source income if the transactions are negotiated and concluded in Hong Kong. It is essential that the proposed exemption give fund managers confidence that their transactions in non-Hong Kong markets will be protected by the proposed legislation.

In light of the above, we believe that the list of specified persons will need to be expanded to reflect the intention of the Bill. We believe that two changes are necessary. First, specified persons should include anyone who is exempt from the need to be licensed. For example, many major industry players are not currently licensed by the SFO to trade foreign exchange, since these entities are exempt from the need to be licensed. If The Bill is enacted in its current form, offshore funds would be prevented from using many major foreign exchange dealers because the SFO does not require them to be regulated. Second, the government should require that transactions be carried out by specified persons only if the underlying product is determined by reference to Hong Kong property. For other property (e.g., a swap denominated by a share listed on the Korean stock exchange), it should not be necessary to use a specified person (as currently defined).

With these suggested revisions, we believe that The Bill will provide the offshore funds industry with the tax certainty they need to expand their operations in Hong Kong.

Linklaters

年利達律師事務所

Memorandum

14 October 2005

To David Sutherland, Capital Markets Tax Committee of Asia Hong Kong Chapter

From Stephen Fletcher

Direct Line 00 852 2901 5350

Profits Tax Exemption for Offshore Funds - Permitted transactions under Securities and Futures Ordinance

1 Executive Summary

The Government has proposed exempting revenue earned by certain offshore persons from Hong Kong profits tax. The Government's proposals are currently set out in the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005. Under the Bill, the exemption is limited primarily to transactions which (a) amount to "dealing in securities", "dealing in futures contracts" or "leveraged foreign exchange trading" under the Securities and Futures Ordinance ("SFO") and (b) are carried out through persons licensed/registered under the SFO for those activities (or, in some cases, for the activity of "asset management").

This memorandum explains why many transactions commonly entered into by offshore funds would fall outside the exemption as drafted – because the definitions of "dealing in securities", etc. under the SFO are relatively limited (see 2 and 3 below), and because often transactions are not entered into through persons who are licensed/registered under the SFO for the relevant activities (see 2 and 4 below). While many transactions typically executed by hedge funds are within the SFO, many transactions are not, including, in particular, many interest rate derivatives, credit derivatives, OTC commodity derivatives, deposits, spot foreign exchange transactions, borrowing/lending money, insurance contracts and physical commodity trading.

We understand that the Government does not intend the exemption to be unduly narrow, and is prepared to introduce amendments to the Bill to extend the exemption appropriately. Accordingly, we have suggested some amendments to help to achieve this.

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2 SFO definitions

This section explains what transactions are caught by the definitions of “dealing in securities”, “dealing in futures contracts” and “leveraged foreign exchange trading” under the SFO.

2.1 Dealing in securities

2.1.1 Introduction

The definition of “dealing in securities” under the SFO is essentially limited to two types of transaction: (1) buying/selling “securities”; and (2) entering into certain derivatives over “securities”. “Securities” is quite broadly defined to include shares, bonds, notes, units in funds, warrants and various physically-settled derivatives over shares, bonds, etc.

However, it obviously does not cover transactions which do not involve “securities”, e.g. interest-rate derivatives, commodity derivatives, foreign exchange derivatives, many ‘credit default’ derivatives, etc.

Please see 3 below.

2.1.2 Definition

“Dealing in securities” is defined under Schedule 5 to the SFO to mean: making (or offering to make) an agreement with another person, or inducing (or attempting to induce) another person to enter into (or to offer to enter into) an agreement:

- (a) for or with a view to acquiring, disposing of, subscribing for or underwriting “securities”; OR
- (b) the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of “securities” or by reference to fluctuations in the value of “securities”.

It is important to note the difference between limbs (a) and (b) above: limb (a) is about buying and selling products that are themselves “securities”; limb (b) is about entering into derivatives which are designed to generate a profit from the income earned on “securities” or from fluctuations in the value of “securities” (i.e., it is not necessary that the derivative in (b) is itself a “security” as defined in the SFO).

“Securities” is defined under Schedule 1 to the SFO to include:

- (a) shares, stocks, debentures, funds, bonds or notes whether issued by a Hong Kong or offshore company, unincorporated body or any governmental authority;
- (b) rights, options or interests in or in respect of any of the instruments in (a);
- (c) certificates of interest in, receipts for or warrants to subscribe for or purchase any of the instruments in (a);
- (d) interests in any “collective investment scheme” (which is itself broadly defined under the SFO to include a broad range of funds); and

- (e) any interests commonly known as securities.

A number of instruments are expressly excluded from the above list. These include: shares and debentures of Hong Kong private companies; interests in collective investment schemes that are registered pension schemes under the Mandatory Provident Fund Schemes Ordinance or Occupational Retirement Schemes Ordinance, or that are also insurance contracts under the Insurance Companies Ordinance; non-investment partnerships; negotiable certificates of deposit; bills of exchange and promissory notes under the Bills of Exchange Ordinance; and non-negotiable/transferable debentures.

The Financial Secretary is also empowered under the SFO to specify that an interest, etc. is or is not a "security" within the above.

We would make several observations about this list:

- There is no requirement that the "securities" be listed or admitted to trading on any stock exchange anywhere
- In relation to (b) above, we have in the past been advised by leading counsel that this only includes physically-settled derivatives over the instruments in (a), e.g. an option contract over shares which allows the holder to call for physical delivery of those shares.
- (e) above is somewhat unhelpful, since in practice it is not at all obvious what other instruments other than those listed in (a) to (d) would commonly be regarded as "securities".
- the exemptions from the list should not be forgotten – in particular the exemptions for insurance contracts, negotiable certificates of deposit and non-negotiable/transferable debentures.

The application of the above to offshore funds' activities in Hong Kong is set out in 3 below.

2.1.3 Exemptions

The SFO sets out a number of exemptions from "dealing in securities". It is important to note that the exemptions work by providing that the specified activity does not fall within the definition of what constitutes "dealing in securities". Three are particularly important in this context:

- a person ("A") is not regarded as "dealing in securities" where the relevant act is performed through another person ("B") who is licensed or registered for "dealing in securities" under the SFO. However, A will not be able to rely on this exemption where, in return for some commission, rebate or other remuneration, A 'deals' with B for the account of a third party or introduces potential clients to B or deals with third parties on behalf of B.
- a person is not regarded as "dealing in securities" where he performs the relevant act as principal and by way of dealing with certain categories of "professional investor" (as defined under the SFO),

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including persons licensed or registered under the SFO, Hong Kong banks, etc.

- a person is not regarded as “dealing in securities” where he acquires, disposes of or subscribes for securities as principal.

The effect of these exemptions is that a person who can benefit from them is not “dealing in securities”. See 3 and 4 below.

2.2 Dealing in futures contracts

2.2.1 Introduction

The definition of “dealing in futures contracts” under the SFO is essentially limited to: buying/selling “futures contracts”, i.e., exchange-traded futures and options on such futures.

The definition does not cover non-exchange traded products, i.e., all off-exchange derivatives.

Please see 3 below.

2.2.2 Definition

“Dealing in futures contracts” is defined under Schedule 5 to the SFO to mean:

- (a) making (or offering to make) an agreement with another person to enter into (or to acquire or dispose of) a “futures contract”;
- (b) inducing (or attempting to induce) another person to enter into (or to offer to enter into) a “futures contract”;
- (c) inducing (or attempting to induce) another person to acquire or dispose of a “futures contract”.

“Futures contract” is defined under Schedule 1 to the SFO to mean a contract (or option on a contract) made under the rules or conventions of a “futures market”.

A “futures market” is, in turn, defined as a place at which facilities are provided for persons to negotiate or conclude sales or purchases of contracts (or options on contracts) the effect of which is that:

- one party agrees to deliver to the other at an agreed future time an agreed (quantity of) property at an agreed price; or
- the parties will make an adjustment between themselves at an agreed future time according to whether an agreed property is worth more or less or an index or other factor stands higher or lower than a value or level agreed at the time of making the contract;

provided that, in both cases, either the contracts (or options) are novated or guaranteed by a central counterparty under the rules or conventions of the market in question, or the contractual obligations of the parties are normally discharged before the contractual expiry date under the rules or conventions of the market in question.

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The application of the above to offshore funds' activities in Hong Kong is set out in 3 below.

2.2.3 Exemptions

The SFO sets out a number of exemptions from "dealing in futures contracts". Again, the exemptions work by providing that the specified activity does not fall within the definition of what constitutes "dealing in futures contract". Two are particularly important in this context:

- a person ("A") is not regarded as "dealing in futures contracts" where the relevant act is performed through another person ("B") who is licensed or registered for "dealing in futures contracts" under the SFO. However, A will not be able to rely on this exemption where, in return for some commission, rebate or other remuneration, A 'deals' with B for the account of a third party or introduces potential clients to B or deals with third parties on behalf of B.
- a person is not regarded as "dealing in futures contracts" where he performs the relevant act as principal in relation to futures contracts traded on any exchange other than the Hong Kong Futures Exchange and by way of dealing with certain categories of "professional investor" (as defined under the SFO), including persons licensed or registered under the SFO, Hong Kong banks, etc.

The effect of these exemptions is that a person who can benefit from them is not "dealing in futures contracts". See 3 and 4 below.

2.3 Leveraged foreign exchange trading

2.3.1 Introduction

The definition of "leveraged foreign exchange trading" under the SFO includes three activities: (1) buying/selling "leveraged foreign exchange contracts"; (2) providing margin facilities to enable another person to engage in spot or leveraged foreign exchange trading; and (3) entering into arrangements to facilitate leveraged foreign exchange trading.

Only the first of these is particularly relevant in the current context.

The definition does not cover 'spot' foreign exchange transactions.

Please see 3 below.

2.3.2 Definition

"Leveraged foreign exchange trading" is defined under Schedule 5 to the SFO to mean:

- (a) the act of entering into or offering to enter into (or inducing or attempting to induce a person to enter into or to offer to enter into) a "leveraged foreign exchange contract";
- (b) the act of providing any financial accommodation to facilitate "foreign exchange trading" or to facilitate an act referred to in (a) above; or

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- (c) the act of entering into or offering to enter into (or inducing or attempting to induce a person to enter into) an arrangement with another person, on a discretionary basis or otherwise, to enter into a contract to facilitate an act referred to in paragraph (a) or (b) above.

“Leveraged foreign exchange contract” is defined under Schedule 5 to the SFO to mean contracts or arrangements the effect of which is that one party agrees to:

- (a) make an adjustment between himself and the other party or another person according to whether a currency is worth more or less (as the case may be) in relation to another currency;
- (b) pay an amount of money or to deliver a quantity of any commodity determined or to be determined by reference to the change in value of a currency in relation to another currency; or
- (c) deliver to the other party or another person at an agreed future time an agreed amount of currency at an agreed consideration.

“Foreign exchange trading” is also defined in Schedule 5 to mean entering into or offering to enter into (or inducing or attempting to induce a person to enter into or to offer to enter into) a contract or arrangement whereby any person undertakes to exchange currency with another person, deliver an amount of foreign currency to another person, or credit the account of another person with an amount of foreign currency.

The application of the above to offshore funds’ activities in Hong Kong is set out in 3 below.

2.3.3 Exemptions

Again, the SFO provides for various exemptions which work by providing that the specified activity does not fall within the definition of what constitutes “leveraged foreign exchange trading”. Several are particularly important in this context:

- where the contract or arrangement is entered into by a company (i) whose principal business is not dealing in currencies, (ii) for the purpose of hedging its exposure to currency exchange risks in connection with its business, and (iii) with another company;
- where the contract or arrangement is arranged by a Hong Kong authorised ‘money broker’ and every party to which is a company or a Hong Kong partnership;
- where the exemptions set out in the Securities and Futures (Leveraged Foreign Exchange Trading – Exemption) Rules apply, i.e., where a person’s principal business is not in leveraged foreign exchange spot transactions, or the average principal amount of each leveraged foreign exchange spot transaction (calculated in accordance with the Rules for the person’s financial year) is not less than HK\$7.8 million, and the person either

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- (a) has a credit rating (or any of its debt instruments has a credit rating) of (i) Moody's – A3 or above for long term debt or Prime-3 or above for short term debt; or (ii) Standard & Poor's – A or above for long term debt or A-3 or above for short term debt; or
- (b) is a wholly owned subsidiary of another company which has such a credit rating (or any of whose debt instruments has such a rating).

Once again, the effect of these exemptions is that a person who can benefit from them is not engaged in “leveraged foreign exchange trading”. See 3 and 4 below.

3 Application to products commonly traded by offshore funds

3.1 Table of products

The table below sets out common activities and products traded by offshore funds with and through Hong Kong brokers, fund managers and counterparties, and notes whether the above SFO definitions apply to those activities and transactions.

Product/Transaction	Caught under above SFO definitions?
1 Foreign exchange/currencies	
Foreign exchange forwards	Yes (leveraged foreign exchange trading)
Foreign exchange options	
Currency swaps	
Spot foreign exchange transactions	No
Deposits	No
Buying/selling certificates of deposit, bills of exchange and promissory notes	No
Borrowing/lending money (in any currency, and whether on a secured or unsecured basis) (including participating as a lender in syndicated loans, selling sub-participations in loans to third parties, etc.)	No
2 Equities	
Buying/selling listed equities (whether in Hong Kong or elsewhere)	Yes (dealing in securities – limb (a))
Buying/selling unlisted equities issued by 'public' companies (whether incorporated in Hong Kong or elsewhere)	Yes (dealing in securities – limb (a))
Buying/selling Hong Kong private equities	No (these equities are not “securities”)

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Product/Transaction	Caught under above SFO definitions?
Buying/selling offshore private equities	Yes (dealing in securities – limb (a))
Stock borrowing and lending and repurchase and reverse-repurchase transactions in equities	Yes (dealing in securities – limb (a)) (assuming that the equities being borrowed/loaned are not those of a Hong Kong private company)
Hedging activities involving buying and selling equities as a hedge to some derivative or other position	Yes (dealing in securities – limb (a)) (assuming that the equities in question are not those of a Hong Kong private company)
Short selling equities (whether on market or off market)	Yes (dealing in securities – limb (a)) (assuming that the equities in question are not those of a Hong Kong private company)
3 Equity derivatives	
Buying/selling exchange-traded futures contracts over equities (including equity index products)	Yes (dealing in futures contracts)
Buying/selling exchange-traded options on futures contracts over equities (including equity index products)	Yes (dealing in futures contracts)
Buying/selling exchange-traded stock option contracts over equities (including equity index products)	Yes (dealing in securities – limb (a))
Entering into OTC equity contracts for differences (whether over one or more equities)	Yes (dealing in securities – limb (b))
Entering into OTC call/put options over equities (physical delivery) (whether over one or more equities)	Yes (dealing in securities – limb (a))
Entering into OTC call/put options over equities (cash settlement) (whether over one or more equities)	Yes (dealing in securities – limb (b))
Entering into OTC forwards over equities (physical delivery) (whether over one or more equities)	Yes (dealing in securities – limb (a))
Entering into OTC forwards over equities (cash settlement) (whether over one or more equities)	Yes (dealing in securities – limb (b))
Entering into OTC equity asset swaps, total return swaps, swaptions (whether over one or more equities)	Yes (dealing in securities – often a combination of limb (a) and limb (b) depending on the terms of the particular transaction)

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Product/Transaction	Caught under above SFO definitions?
Buying/selling warrants (whether exchange traded or OTC)	Yes (dealing in securities – limb (a))
Entering into OTC swaps of dividend on equities against some other income stream (whether over one or more equities)	Yes (dealing in securities – limb (b))
4 Funds	
Buying/selling funds (whether exchange traded or not)	Yes (dealing in securities – limb (a))
Buying/selling funds of funds	Yes (dealing in securities – limb (a))
Buying/selling hedge funds	Yes (dealing in securities – limb (a))
Entering into OTC call/put options over funds (physical delivery) (whether over one or more funds)	Yes (dealing in securities – limb (a))
Entering into OTC call/put options over funds (cash settlement) (whether over one or more funds)	Yes (dealing in securities – limb (b))
Entering into OTC forwards over funds (physical delivery) (whether over one or more funds)	Yes (dealing in securities – limb (a))
Entering into OTC forwards over funds (cash settlement) (whether over one or more funds)	Yes (dealing in securities – limb (b))

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5 Fixed income	
Buying/selling any listed bonds, debentures or notes (whether in Hong Kong or elsewhere) (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes, asset-backed securities, mortgage-backed securities)	Yes (dealing in securities – limb (a))
Buying/selling any unlisted bonds, debentures or notes issued by 'public' companies (whether incorporated in Hong Kong or elsewhere) (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes)	Yes (dealing in securities – limb (a))
Buying/selling any unlisted bonds, debentures or notes issued by Hong Kong private companies (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes)	No (if these instruments are "debentures", they are not "securities")
Buying/selling any unlisted bonds, debentures or notes issued by offshore private companies (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes)	Yes (dealing in securities – limb (a))
Stock borrowing and lending and repurchase Stock borrowing and lending and repurchase and reverse-repurchase transactions in any bonds, debentures or notes	Yes (dealing in securities – limb (a)) (assuming that any debentures being borrowed/loaned are not those of a Hong Kong private company)
Hedging activities involving buying and selling any bonds, debentures or notes as a hedge to some derivative or other position	Yes (dealing in securities – limb (a)) (assuming that any debentures in question are not those of a Hong Kong private company)
Short selling any bonds, debentures or notes (whether on market or off market)	Yes (dealing in securities – limb (a)) (assuming that any debentures in question are not those of a Hong Kong private company)
6 Fixed income derivatives	
Entering into OTC call/put options over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes)	Yes (dealing in securities – limb (a))
Entering into OTC call/put options over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures	Yes (dealing in securities – limb (b))

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or notes)	
Entering into OTC forwards over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes)	Yes (dealing in securities – limb (a))
Entering into OTC forwards over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures or notes)	Yes (dealing in securities – limb (b))
Entering into OTC bond, debenture or note asset swaps, total return swaps, swaptions (whether over one or more bonds, debentures or notes)	Yes (dealing in securities – often a combination of limb (a) and limb (b) depending on the terms of the particular transaction)
Entering into OTC swaps of interest paid on bonds, debentures or notes against some other income stream (whether over one or more bonds, debentures or notes)	Yes (dealing in securities – limb (b))
Entering into OTC credit default swaps (cash settled)	No
Entering into OTC credit default swaps (physical delivery of the underlying reference obligations)	No (unless reference obligations themselves are or include bonds, debentures or notes, in which case, yes – dealing in securities – limb (a))
Buying/selling credit-linked notes (whether listed or unlisted)	Yes (dealing in securities – limb (a))
Buying/selling collateralised debt obligations	Yes (dealing in securities – limb (a))
7 Interest rate derivatives	
Entering into OTC interest rate swaps (whether fixed rate v fixed rate, fixed rate v floating rate, or floating rate v floating rate)	No (unless also some currency element to the swap in which case it might be leveraged foreign exchange trading)
Entering into OTC interest rate options, swaptions, caps, collars, floors, etc.	No (unless also some currency element to the swap in which case it might be leveraged foreign exchange trading)
8 Commodities	
Buying/selling commodities (physical delivery)	No
Buying/selling exchange-traded futures contracts over commodities (including commodity index products)	Yes (dealing in futures contracts)

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Buying/selling exchange-traded options on futures contracts over commodities (including commodity index products)	Yes (dealing in futures contracts)
Entering into OTC commodity contracts for differences (whether over one or more commodities)	No
Entering into OTC call/put options over commodities (physical delivery) (whether over one or more commodities)	No
Entering into OTC call/put options over commodities (cash settlement) (whether over one or more commodities)	No
Entering into OTC forwards over commodities (physical delivery) (whether over one or more commodities)	No
Entering into OTC forwards over commodities (cash settlement) (whether over one or more commodities)	No
Entering into OTC commodity asset swaps, total return swaps, swaptions (whether over one or more commodities)	No
9 Other investments and derivatives	
Buying/selling insurance policies	No (although entering into certain investment-linked insurance policies arguably amounts to dealing in securities – limb (b))
Entering into OTC energy derivatives (e.g. over electricity supply/capacity)	No
Entering into OTC weather derivatives	No
Entering into OTC freight derivatives	No
Entering into OTC derivatives over insurance policies	No
Entering into OTC derivatives over inflation rates and economic statistics	No
Entering into derivatives on derivatives	Maybe, depending on the terms of the particular transaction

As can be seen from the above table, while many transactions typically executed by hedge funds are within the SFO, many transactions are not, including in particular many interest rate derivatives, credit derivatives, OTC commodity derivatives, deposits, spot

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foreign exchange transactions, borrowing/lending money, insurance contracts and physical commodity trading

3.2 SFO exemptions

As noted in 2 above, there are a series of exemptions from the SFO definitions of “dealing in securities”, “dealing in futures contracts” and “leveraged foreign exchange trading”. We assume that the Government did not intend these exemptions to apply in relation to these definitions in the context of the profits tax exemption. Otherwise, if the exemptions were to apply, many offshore funds would not, say, be “dealing in securities” (because they were dealing as principal with professional investors, i.e., their brokers), and so could never benefit from the proposed profits tax exemption.

The Government should be asked to clarify that this was not its intention.

4 Transactions through Hong Kong licensed/registered persons

As noted above, one of the requirements for the profits tax exemption is that the relevant transaction must normally be carried out through an appropriately licensed/registered person under the SFO. For example, transactions amounting to “leveraged foreign exchange trading” must be carried out by the offshore fund through (among others) a firm licensed under the SFO for “leveraged foreign exchange trading” or a Hong Kong bank.

While these conditions will often be met, we believe that there will be a number of occasions where they will not be met. For example, many firms in Hong Kong are not regarded as carrying on “leveraged foreign exchange trading” and so do not need to be licensed under the SFO for this activity, because they rely on one of the exemptions (e.g. the exemption under the Securities and Futures (Leveraged Foreign Exchange Trading – Exemption) Rules). An offshore fund will not be able to deal with such firms if it wishes to rely on the proposed profits tax exemption as currently drafted.

Similarly, many brokers in Hong Kong operate as ‘introducing brokers’ where they introduce business from Hong Kong investors to their offshore affiliates or third-party brokers to execute. In this case, although a Hong Kong licensed person might be involved (at least in passing the investor’s order to the affiliate), it may not be correct to say that the transaction has been “carried out through” the Hong Kong broker – it would be more accurate to say that the transaction had been arranged by the Hong Kong broker but had been “carried out through” the offshore broker. The current draft of the exemption may not capture these sorts of arrangements, which we assume was not the Government’s intention.

Moreover, the fact that an offshore fund has an SFO licensed asset manager in Hong Kong will not always help either. The way in which “asset managers” are currently brought within the proposed profits tax exemption is by referring to the ‘asset manager exemptions’ to the activities of “dealing in securities” and “dealing in futures contracts”. Unfortunately, these exemptions require that the manager be acting solely for the purpose of carrying on its asset management activity under the SFO, i.e., managing a portfolio of “securities” or “futures contracts”. In other words, while this covers transactions in “securities” and “futures contracts” and, arguably, other transactions which are a necessary part of managing a portfolio of “securities” and “futures contracts” (e.g. derivative transactions to manage the risks attached to the portfolio), it would not, in our view, cover unconnected transactions, e.g. commodity derivative transactions, physical commodity trading, etc.

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Indeed we should also point out that some fund managers in Hong Kong do not even need to be licensed for their asset management activities. Where an fund manager provides services to its 100% group companies in relation to the securities and futures contracts owned by those companies, the asset manager is not regarded as carrying on the SFO regulated activity of asset management and so does not need to be licensed for this activity. This is perhaps most often the case in relation to offshore insurance companies which set up a Hong Kong subsidiary to manage the Hong Kong part of the securities/futures contracts portfolio of the offshore insurer. The proposed profits tax exemption would not cover this. In addition, to the extent that the fund manager provides asset management services in relation to other products which do not constitute "securities" or "futures contracts", no "asset management" licence is needed under the SFO in any event. Again, the proposed profits tax exemption would not cover these activities.

Finally, if the exemption is extended to cover additional products not covered by the SFO, the requirement that the relevant transaction be effected through an SFO licensed or registered person (or one of the other limited, permitted categories) no longer makes sense.

5 Suggestions on amending the current draft of the proposed exemption

This section sets out our suggestions as to how the Bill could be amended to extend the profits tax exemption.

5.1 List of products

In addition to the types of investment activity currently permitted under the proposed exemption from profits tax, we believe that the following investment activities should also be allowed:

- spot foreign exchange transactions;
- deposits, certificates of deposit, bills of exchange and promissory notes;
- loans;
- unlisted bonds, debentures or notes issued by Hong Kong private companies;
- credit derivatives;
- interest rate derivatives;
- commodities and OTC commodity derivatives;
- insurance contracts and derivatives over insurance contracts;
- other commonly-traded derivative contracts, e.g. weather derivatives, energy derivatives, etc.

We would also suggest that the Government reserve the power to add to the list, in order to allow it to deal with changing markets, new products, etc.

As transactions in the above products, and indeed certain dealings in securities and futures contracts and leveraged foreign exchange trading under the SFO, are not and are not required to be carried out by or through someone who is licensed under the SFO, we believe that changes would be required to the proposed exemption to cover this.

We have suggested below some changes to the drafting of the proposed exemption to deal with these issues.

5.2 Suggested drafting

- Section 20AB would need to be amended to include two new definitions used in our amended subsection 20AC(2):

“permitted person” means any person who is licensed, registered or authorised under the laws of Hong Kong or under the law of any place outside Hong Kong to carry on any business involving a permitted transaction, or who is not required under such laws to be so licensed, registered or authorised;”

“permitted transaction” means any transaction involving one or more of the instruments, transactions or activities specified in Schedule [] to this Ordinance;
- We would suggest that subsection 20AC(1)(a) be amended to read:

“(a) transactions falling within subsection (2) that are entered into or performed or otherwise carried out in the year of assessment; and”
- We would suggest that subsection 20AC(2) be amended to read:

“(2) A transaction falls within this subsection if –

(a) the transaction involves a permitted transaction; and

(b) the transaction is entered into with or through or arranged by a permitted person.”
- In light of our suggested amendments to subsection 20AC(2), subsections (3) and (4) can be deleted. We also believe that subsection 20AC(5) could be deleted too.
- A new Schedule would need to be inserted to set out the list of permitted transactions. As noted above, this should build on the activities already covered by the Bill (i.e., “dealing in securities”, “dealing in futures contracts”, and “leveraged foreign exchange trading”):
 1. *A dealing in securities within the meaning of paragraph (a) or (b) (excluding paragraphs (i) to (xiv)) of the definition of “dealing in securities” in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571);*
 2. *A dealing in futures contracts within the meaning of paragraph (a), (b) or (c) (excluding paragraphs (i) to (vii)) of the definition of “dealing in futures contracts” in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571);*
 3. *Leveraged foreign exchange trading within the meaning of paragraph (a), (b) or (c) (excluding paragraphs (i) to (xv)) of the definition of “leveraged foreign exchange trading” in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571);*
 4. *Foreign exchange trading within the meaning of the definition of “foreign exchange trading” in Part 2 of Schedule 5 to the Securities and Futures*

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Ordinance (Cap. 571) (but excluding paragraphs (i) to (xv) of the definition of "leveraged foreign exchange trading" in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571));

5. A transaction within the meaning of the definition of "regulated investment agreement" in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);

6. A deposit (in any currency) within the meaning of paragraph (a) of the definition of "deposit" in Section 2(1) of the Banking Ordinance (Cap. 155);

7. A negotiable receipt, certificate or document evidencing the deposit of a sum of money (in any currency), or any right or interest arising under or in respect of such receipt, certificate or document;

8. A bill of exchange within the meaning of section 3 of the Bills of Exchange Ordinance (Cap. 19) and a promissory note within the meaning of section 89 of that Ordinance;

9. A loan (in any currency) within the meaning of the definition of "loan" in Section 2(1) of the Money Lenders Ordinance (Cap. 163);

10. A contract of insurance in relation to any class of insurance business specified in Parts 2 and 3 of Schedule 1 to the Insurance Companies Ordinance (Cap. 41);

11. A transaction involving the physical delivery of any commodity;

12. A derivative instrument for the transfer of credit risk;

13. Any debenture, loan stock, bond or note issued by a company that is a private company within the meaning of section 29 of the Companies Ordinance (Cap. 32);

14. Any option, future, swap, forward rate agreement and any other derivative contract that can be settled physically or in cash relating to commodities, contracts of insurance, interest rates or yields, other derivative contracts, a financial index or measure, a climactic variable, freight rates, energy, emission allowances, inflation rates or other official economic statistics, as well as any other derivative contract relating to assets, rights, obligations, indices or measures not otherwise mentioned in this Schedule; and

15. Any transaction, instrument, interest, right or property which is a transaction, instrument, interest, right or property, or is of a class or description of transaction, instrument, interest, right or property, prescribed [by the Financial Secretary by notice under []] for the purposes of this Schedule.

If you have any queries in relation to any part of this memorandum, please let me know.

Stephen Fletcher
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